

RENZ D. JENNINGS  
CHAIRMAN

MARCIA WEEKS  
COMMISSIONER

CARL J. KUNASEK  
COMMISSIONER



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JAMES MATTHEWS  
EXECUTIVE SECRETARY

RATION COMMISSION

DATE: June 14, 1996

DOCKET NO: U-1303-96-055

TO ALL PARTIES:

Enclosed please find the recommendation of Hearing Officer Lyn Farmer. The recommendation has been filed in the form of an Order on:

Paradise Valley Water Company (Finance)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Hearing Officer by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by 5:00 p.m. on or before:

June 24, 1996

The enclosed is NOT an order of the Commission, but a recommendation of the Hearing Officer to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

June 25, 1996 and June 26, 1996

For more information, you may contact Docket Control at (602)542-3477 or the Hearing Division at (602)542-4250.

  
James Matthews  
EXECUTIVE SECRETARY

JM  
Enc.  
cc: ALL PARTIES

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 RENZ D. JENNINGS  
CHAIRMAN  
3 MARCIA WEEKS  
COMMISSIONER  
4 CARL J. KUNASEK  
COMMISSIONER

5 IN THE MATTER OF THE APPLICATION OF )  
6 PARADISE VALLEY WATER COMPANY FOR )  
7 AUTHORIZATION TO INCREASE THE LINE )  
8 OF CREDIT WITH MELLON BANK TO )  
\$6,780,000 AND SUBSEQUENTLY REPAY )  
9 THE LINE OF CREDIT BY THE SALE OF )  
\$7,000,000 OF SECURITIES. )

DOCKET NO. U-1303-96-055

DECISION NO. \_\_\_\_\_

**ORDER**

10 Open Meeting  
June 26, 1996  
11 Phoenix, Arizona

12 **BY THE COMMISSION:**

13 Paradise Valley Water Company ("PVWC" or "Applicant" or "Company") is a subchapter "C"  
14 corporation which provides water service within portions of the Town of Paradise Valley, the City of  
15 Scottsdale, and certain unincorporated areas within Maricopa County. As of December 31, 1995,  
16 Applicant provided water service to approximately 4,400 customers.

17 On January 31, 1996, PVWC filed an application with the Arizona Corporation Commission  
18 ("Commission") requesting approval of its proposed financing. On April 11, 1996, the Commission's  
19 Utilities Division Staff ("Staff") filed its Staff Report in this matter. On May 23, 1996, PVWC filed its  
20 Response to the Staff Report. On May 29, 1996, Staff filed its Comments to PVWC's Response, and on  
21 May 31, 1996, PVWC filed its Reply Memorandum.

22 **DISCUSSION**

23 Decision No. 57305 (April 3, 1991) granted PVWC its initial authorization for its Mellon Bank  
24 line of credit. Subsequently, PVWC has been granted Commission authority to increase its line of credit  
25 on six occasions. The current borrowing limit of \$3,070,000 was authorized by Decision No. 59472  
26 (December 15, 1995). The proposed limit would increase the borrowing limit to \$6,780,000. The  
27 additional capital is needed to complete extensive construction projects undertaken in response to  
28 emergency water pressure problems which occurred during the summer of 1995.

1       The Applicant's line of credit agreement with Mellon Bank is negotiated annually and is effective  
2 from July 1 of any year to June 30 of the following year. In January 1996, Mellon Bank authorized a line  
3 of credit for PVWC in the amount of \$6,360,000. The Applicant's request for Commission approval to  
4 increase its line of credit to \$6,780,000 includes its anticipated borrowing for July and August 1996. At  
5 the time it takes a cash advance, the Applicant can choose between two interest rate options: a rate equal  
6 to the average daily Federal Funds rate plus one percent; or Mellon Bank's announced Prime Rate. The  
7 Applicant projects paying an annual interest rate of 6.75 percent and an annual facility fee of  
8 approximately \$16,950.

9       According to the Staff Report, Mellon Bank provides short-term lines of credit for Applicant and  
10 many of the other subsidiaries of Applicant's parent company, American Water Works, Inc. ("AWA").  
11 Mellon Bank has agreed to increase the line of credit by \$3,290,000, for a total of \$6,360,000. According  
12 to PVWC, although Mellon Bank has allowed the line of credit to grow annually, now that the line of  
13 credit has increased rapidly, Mellon Bank expects PVWC to pay off its line of credit on an annual basis,  
14 as per the line of credit agreements. PVWC intends to pay off its short-term line of credit through the  
15 issuance of \$7,000,000 of common stock which would be purchased by AWA. Subsequent to the  
16 proposed stock issuance, PVWC plans to again meet its capital needs through short-term debt, and at the  
17 time that Applicant's amount of debt approaches a level which can be marketed into mortgage bonds,  
18 Applicant intends to issue bonds and convert its short-term debt into long-term debt.

19       Staff recommended approval of the application to increase Applicant's line of credit with Mellon  
20 Bank to \$6,780,000. Staff believes that this additional financing is necessary in order to fund PVWC's  
21 construction projects, but Staff also recommends that Applicant maintain detailed records of construction  
22 expenditures to allow Staff to thoroughly analyze all proposed additions to rate base in a rate case  
23 proceeding.

24       Staff recommended that Applicant's request for approval to issue \$7 million in common equity  
25 securities to repay the short-term line of credit not be approved because Staff does not believe that the  
26 proposed 100 percent equity long-term financing is in the public interest. As the basis for its  
27 recommendation, Staff notes that as a general rule, equity is more expensive than debt; that dividends  
28 are not tax deductible whereas interest payments are and would lower the income tax liability which

1 ratepayers must absorb; that the Applicant's proposal would result in an inappropriate capital structure;  
2 and that PVWC has not taken advantage of the financial resources available to it by obtaining the debt  
3 financing from its parent, who has agreed to guarantee its short-term debt. Staff believes that the  
4 Applicant's proposal does not allow it to obtain the lowest cost debt financing available and concludes  
5 that Applicant is not acting in a manner compatible with sound financial practices, nor is it acting for the  
6 benefit of ratepayers.

7 Staff recommends that Applicant repay its short-term line of credit through the issuance of \$4.5  
8 million of long-term debt and \$2.5 million of common stock, resulting in a projected capital structure of  
9 approximately 48 percent debt and 52 percent equity. Staff believes that the interest rate on the newly  
10 issued long-term debt should not exceed 8.50 percent and that Applicant should be ordered to file all  
11 long-term debt terms, conditions, covenants, and restrictions for Staff approval.

12 The Company opposes Staff's recommendation that the short-term line of credit be paid off with  
13 a combination of funds generated through both common stock and long-term debt. PVWC argues that  
14 Staff assumes that a "balanced" capital structure is better for the utility and its customers and that AWA  
15 is available to loan large amounts to PVWC. The Company also argues that AWA did not guarantee  
16 repayment of the short-term line of credit with Mellon Bank, but "advised Mellon Bank that it will  
17 contribute additional equity capital to the Company to ensure that the Company can repay the line of  
18 credit by June 30." The Company believes that the issue of the appropriate capital structure should be  
19 addressed in a general rate proceeding rather than a financing application.

20 There is no dispute that the projects to be funded by the proposed financing are appropriate and  
21 necessary. Clearly, AWA has \$7,000,000 available for PVWC to use to pay off its short-term line of  
22 credit.<sup>1</sup> However, according to the Company, those funds will be provided only as an equity infusion,  
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24

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25 <sup>1</sup> The Company has indicated to Staff that Mellon Bank expects PVWC to pay off its line  
26 of credit on an annual basis, as per the line of credit agreements, but PVWC has not submitted in the  
27 docket documentation to support this change in policy, nor has it submitted documentation that it  
28 requested the line of credit be rolled into the next year. PVWC did provide a January 9, 1996 letter to  
Mellon Bank indicating that AWA anticipated injecting "about \$7 million of equity through purchase of  
the Company's stock around September, 1996". See Exhibit H to PVWC's application.

1 and not as a loan.<sup>2</sup>

2 Based upon the information provided by the Company, we find it difficult to conclude that the  
3 \$7 million equity issuance is "compatible with the public interest, [and] with sound financial practices"<sup>3</sup>  
4 when the Company's capital structure will change from 59 percent debt and 41 percent equity, to 3  
5 percent debt and 97 percent equity. This is especially true given the timing of the issuance and the  
6 pendency of the Company's rate application. All the evidence submitted to date indicates that the  
7 Company has timed the issuance of its common stock to increase the equity portion of its capital  
8 structure, thereby significantly increasing its cost of capital and consequently its requested revenue  
9 increase.

10 However, we will grant the Company's request with the following conditions. The Company is  
11 put on notice that our approval of the equity issuance is not approval or adoption of the Company's use  
12 of its "projected at 12/31/96 capital structure"<sup>4</sup> in its pending rate application. In granting this financing  
13 application, we are not making a finding that the Company's decision to issue equity is the appropriate  
14 method to complete the financing of the projects. The Commission in the past has been somewhat  
15 reluctant to use a "hypothetical" capital structure, and Staff urges us to order the Company to make such  
16 a ratemaking adjustment in the pending rate proceeding. While we will not order an adjustment in this  
17 financing docket, such an adjustment, or the use of an appropriate actual test year capital structure, may  
18 be appropriate and will be determined in the rate proceeding. The burden will be on the Company during  
19 its pending rate proceeding if it expects the Commission to adopt a capital structure which includes the  
20 equity issuance approved in this financing application. The Company should be prepared to present  
21 evidence showing that, after serious negotiations, Mellon Bank refused to continue any short-term line  
22 of credit under any reasonable conditions; that the Company made serious good faith efforts to obtain  
23

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24 <sup>2</sup> The Company's cost of short-term debt is approximately 6.6 percent, however, in its rate  
25 application filed on April 9, 1996 (Docket No. U-1303-96-283), the short-term debt has been replaced  
26 with common equity at a cost of 12 percent.

27 <sup>3</sup> A.R.S. §40-301.C

28 <sup>4</sup> Instead of using its actual capital structure as of the end of the test year, PVWC, in its  
pending rate application, used a "projected at 12/31/96" capital structure, which assumes the Commission  
will approve this financing application.

1 a long-term loan, and was unsuccessful; and any other evidence which would demonstrate why issuance  
2 of equity was in the public interest.

### 3 FINDINGS OF FACT

4 1. Applicant is an Arizona corporation engaged in the business of providing water utility  
5 service to the public in Maricopa County, Arizona, pursuant to authority granted by the Commission.

6 2. On January 31, 1996, PVWC filed with the Commission an application requesting  
7 approval to increase its line of credit with Mellon Bank to \$6,780,000 and for approval to subsequently  
8 issue \$7 million in common equity securities to pay off its short-term line of credit.

9 3. On May 3, 1996, Applicant provided notice of the application to its customers.

10 4. Pursuant to the proposed terms of the financing, Applicant would increase its authorized  
11 short-term line of credit with the Mellon Bank by \$3,710,000, to a total authorization of \$6,780,000.  
12 Additionally, Applicant would issue \$7 million in common equity securities to repay the short-term line  
13 of credit.

14 5. The principal purpose for which the proceeds of the financing will be utilized is to provide  
15 sufficient capital to finance extensive construction projects designed to alleviate water pressure problems,  
16 and to repay the short-term line of credit.

17 6. Staff has reviewed the projects to be funded by the proceeds of the financing, as well as  
18 the construction costs, and found them to be appropriate.

19 7. On April 11, 1996, Staff filed its Staff Report in this matter recommending that the  
20 application to increase the short-term line of credit with Mellon Bank to \$6,780,000 be approved. Staff  
21 recommended that the application for approval to issue \$7 million in common equity securities be denied  
22 and instead Applicant be authorized to issue up to \$2.5 million in equity securities and up to \$4.5 million  
23 in long-term debt securities.

24 8. In addition to recommending approval of the application, Staff recommends that:

25 Applicant be ordered to submit the long-term debt agreement, including all terms,  
26 conditions, covenants, and restrictions for Staff's review and approval;

27 Applicant be allowed a maximum interest rate of 8.5 percent on its newly issued long-  
term debt; and

28 Applicant be ordered to maintain detailed records of construction expenditures to allow

1 Staff to thoroughly analyze all proposed additions to rate base in any future rate case  
2 proceeding.

3 9. PVWC's request to increase its short-term line of credit to \$6,780,000 should be approved.

4 10. The Company opposes Staff's recommendation that the short-term line of credit be paid  
5 off with a combination of funds generated through both common stock and long-term debt.

6 11. PVWC's capital structure as of December 31, 1995 consisted of approximately 59 percent  
7 debt and 41 percent equity.

8 12. Increasing common equity by \$7 million would result in a capital structure for PVWC of  
9 approximately 3 percent debt and 97 percent equity.

10 13. All the evidence submitted to date indicates that the Company has timed the issuance of  
11 its common stock to increase the equity portion of its capital structure, thereby significantly increasing  
12 its cost of capital and consequently its requested revenue increase.

13 14. PVWC's request to issue \$7 million in equity securities should be approved with the  
14 conditions contained herein.

15 15. The Company is put on notice that our approval of the equity issuance is not approval or  
16 adoption of the Company's use of its "projected at 12/31/96 capital structure" in its pending rate  
17 application.

18 16. In granting this financing application, we are not making a finding that the Company's  
19 decision to issue equity is the appropriate method to complete the financing of the projects.

20 17. The burden will be on the Company during its pending rate proceeding to convince the  
21 Commission to adopt a capital structure which includes the equity issuance approved in this financing  
22 application.

23 18. The Company should be prepared to present evidence showing that, after serious  
24 negotiations, Mellon Bank refused to continue any short-term line of credit under any reasonable  
25 conditions; that the Company made serious good faith efforts to obtain a long-term loan, and was  
26 unsuccessful; and any other evidence which would demonstrate why issuance of equity was in the public  
27 interest.

28 19. Staff's recommendation as set forth in Findings of Fact No. 8, to require PVWC to

maintain detailed records of construction expenditures should be approved.

### CONCLUSIONS OF LAW

1. Applicant is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. §§40-301 and 40-302.

2. The Commission has jurisdiction over Applicant and the subject matter of the application.

3. Applicant caused notice of its application in this matter to be duly published.

4. The requested financing, with the conditions contained herein, should be approved.

5. The financing, with the conditions approved herein, is for lawful purposes within Applicant's corporate powers, is compatible with the public interest, with sound financial practices, and with the proper performance by Applicant of service as a public service corporation, and will not impair Applicant's ability to perform that service.

6. The financing approved herein is for the purposes stated in the application and is reasonably necessary for those purposes, and such purposes are not, wholly or in part, reasonably chargeable to operating expenses or to income.

### ORDER

IT IS THEREFORE ORDERED that Paradise Valley Water Company is hereby authorized to increase its short-term line of credit with Mellon Bank by \$3,710,000, to a total authorization of \$6,780,000.

IT IS FURTHER ORDERED that Paradise Valley Water Company is hereby authorized to issue up to \$7,000,000 in equity securities, with the conditions discussed herein.

IT IS FURTHER ORDERED that approval of the financing set forth hereinabove does not constitute or imply approval of the use of the equity issuance in the capital structure to be used in the Company's pending rate application.

IT IS FURTHER ORDERED that Paradise Valley Water Company shall maintain detailed records of all related construction expenditures.

IT IS FURTHER ORDERED that Paradise Valley Water Company is hereby authorized to engage in any transactions and to execute any documents necessary to effectuate the authorization granted hereinabove.



IT IS FURTHER ORDERED that such authority shall be expressly contingent upon Paradise Valley Water Company's use of the proceeds for the purposes set forth in the application.

IT IS FURTHER ORDERED that approval of the financing set forth hereinabove does not constitute or imply approval or disapproval by the Commission of any particular expenditure of the proceeds derived thereby for purposes of establishing just and reasonable rates.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN

COMMISSIONER

COMMISSIONER

IN WITNESS WHEREOF, I, JAMES MATTHEWS, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this \_\_\_\_ day of \_\_\_\_, 1996.

JAMES MATTHEWS  
EXECUTIVE SECRETARY

DISSENT  
LAF:dap

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